P-421/EI-89-860 AFTER RECONSIDERATION AND CLARIFYING ORDER OF JUNE 7

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Darrel L. Peterson	Chair
Cynthia A. Kitlinski	Commissioner
Norma McKanna	Commissioner
Robert J. O'Keefe	Commissioner
Patrice Vick	Commissioner

In the Matter of Northwestern Bell Telephone Company's, d/b/a U S West Communications, Proposed Incentive Regulation Plan

ISSUE DATE: September 17, 1990

DOCKET NO. P-421/EI-89-860

ORDER AFTER RECONSIDERATION AND CLARIFYING ORDER OF JUNE 7

PROCEDURAL HISTORY

I. The Order at Issue

On June 7, 1990 the Commission issued its FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER in this matter. That Order accepted Northwestern Bell Telephone Company's (Northwestern Bell or the Company) proposed incentive regulation plan, as modified under the terms of the Order.

The Company, the Department of Public Service (the Department), the Residential Utilities Division of the Office of the Attorney General (RUD-OAG), and the Senior Citizens Coalition of Northeastern Minnesota (the Seniors) filed timely petitions for reconsideration. MCI Communications Corporation (MCI) and the Minnesota Independent Coalition filed replies to the petitions, as did the petitioners.

The Company, the Department, and the RUD-OAG also requested clarification of portions of the June 7 Order.

The matter came before the Commission on August 21 and August 22, 1990.

FINDINGS AND CONCLUSIONS

II. Issues Raised by Petitioners

The petitions for reconsideration and clarification raised the following issues:

> (1) whether cost increases or decreases resulting from government action should be passed through to ratepayers;
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> (2) whether the 13.74% threshold for sharing increased earnings with ratepayers is appropriate;
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> (3) whether the 18.5% absolute return on equity, the point beyond which all earnings must be refunded to ratepayers, is appropriate;
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> (4) whether the tracker mechanism, established to monitor revenue decreases resulting from reductions in the prices of competitive services, could or should be used to impute revenues to the Company;
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> (5) whether full information on individually priced services should be included in the Company's tracker reports;
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> (6) whether sharing of increased earnings should be limited to users of noncompetitive services;
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> (7) whether the Commission should clarify its discussion of the appropriateness of existing rates to make it clear that required rate of return, not authorized rate of return, is the crucial factor;
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> (8) whether the Commission should clarify its discussion of capital structure to make it clear that its use of actual capital structure in this case does not signal a rejection of hypothetical capital structure in ratemaking or in other incentive plan proceedings where it may be appropriate;
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> (9) whether the Commission should modify the Order's reporting requirements on the economic development effects of the Company's rural modernization program.

Each issue will be addressed in turn.

III. Pass Throughs

The June 7 Order rejected Northwestern Bell's proposal to allow the Company to petition for rate adjustments to pass through two cost increases expected to result from government action[1], and to disallow petitions from other parties to pass through government-related cost decreases. The

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[1] Those two increases were expected to result from accounting changes in recording post-retirement benefits adopted by the Financial Accounting Standards Board and marketing expense separations changes required by the FCC and the Joint Board.

Commission amended the plan to allow any party to request pass through of government-related cost increases or decreases, to allow the Commission to initiate pass through proceedings, and to allow parties to bring forward offsetting cost increases or decreases in pass through proceedings.

The Company and the RUD-OAG asked the Commission to eliminate all pass throughs on reconsideration. MCI did not file for reconsideration, but in its reply comments supported eliminating pass throughs. The Department and the Minnesota Independent Coalition did not seek reconsideration on the issue, but stated they did not oppose eliminating pass throughs. The Seniors supported the pass through provisions of the June 7 Order.

The Commission will eliminate pass throughs on reconsideration.

There were two primary reasons for the pass through provisions of the June 7 Order. One was Commission reluctance to force the Company, over its protests, to absorb cost increases beyond its control. This concern was eliminated by the Company's request to eliminate the pass through provisions of the Order. The other was to prevent windfalls to the Company from cost reductions for which it could take no credit. This concern can be met by other means; in this case, by a modest reduction in the sharing threshold, discussed later.

Furthermore, as the Company and the RUD-OAG have pointed out, eliminating pass throughs will increase rate stability under the plan and prevent expensive, time-consuming pass through proceedings before the Commission. Rate stability is one of the primary benefits of incentive plan regulation, and one the Commission is pleased to further. Eliminating pass through proceedings will conserve the resources of the Company, the Commission, the intervenors, and other potentially interested parties. It will reduce regulatory costs for ratepayers and further the statutory goal of minimizing day-to-day regulation of companies operating under incentive plans. For all these reasons, the Commission will grant the request of the Company and the RUD-OAG to eliminate pass throughs under the plan.

IV. Sharing Threshold

The Department, the RUD-OAG, and the Seniors requested reconsideration and reduction of the 13.74% sharing threshold set in the June 7 Order. In its reply comments, MCI supported lowering the sharing threshold.

The Commission is convinced that some reduction in the sharing threshold is in order. First of all, the Commission has reduced the risks the plan imposes on the Company by granting its request to eliminate pass throughs.[2] Since the sharing threshold is supposed to reflect the relative risks the plan imposes on ratepayers and shareholders, any reduction in shareholders' risks should be accompanied by a reduction in the sharing threshold. Minn. Stat. § 237.625 (Supp. 1989).

Furthermore, on reconsideration the Commission believes a 13.5% sharing threshold will give the Company adequate incentive to identify and exploit untapped operating efficiencies. That threshold, together with the use of actual capital structure, will still allow the Company to retain approximately $10 million in earnings over its authorized rate of return. The Commission will therefore reduce the sharing threshold to 13.5%.

V. Absolute Return on Equity

The Seniors requested reconsideration and reduction of the 18.5% absolute return on equity, the point above which the Company must refund all earnings to ratepayers. The RUD-OAG expressed general agreement with the positions taken in the Seniors' petition for reconsideration.

The Seniors sought reconsideration on grounds that the 18.5% maximum return on equity is unreasonably high. The Commission disagrees. As the Order explained, the 18.5% maximum was established to serve two goals: to give the Company adequate incentive to exploit untapped operating efficiencies to the fullest and to protect the public from exorbitant monopoly profits. The Commission continues to believe the 18.5% maximum return accomplishes both goals. Furthermore, many state regulatory commissions have approved incentive plans with no maximum return on equity, undermining the claim that an 18.5% absolute return on equity is unreasonable on its face. The Commission will therefore retain the 18.5% absolute return on equity set in the June 7 Order.

VI. Imputation of Revenues Reported Through the Tracker Mechanism

The Company asked the Commission to clarify that the Order's requirement to report revenues from

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[2] The parties disagree on whether eliminating pass throughs is more likely to benefit the Company or the ratepayers. The issue is far from settled. The Company, however, obviously believes eliminating pass throughs reduces its risks under the plan. Furthermore, the one government-related cost change which is certain to occur during the life of the plan -- the phase-out of Minnesota's gross receipts tax -- will benefit the Company.

competitive services in accordance with the "tracker mechanism" provisions of Minn. Stat. § 237.62, subd. 1a (d) (Supp. 1989) did not anticipate automatic imputation of price reductions as revenues to the Company. The Company is correct that the Commission did not intend to adopt automatic imputation of revenues under the June 7 Order.

The purpose of the tracker reports is to allow immediate identification and investigation of possible incidents of cross-subsidization. While the tracker reports could prompt investigation, and could support a subsequent decision to impute revenues from reductions in prices for competitive services, the reports will not, in and of themselves, result in imputation of revenues.

VII. Inclusion of Individually Priced Services in Tracker Reports

The Company requested clarification that the reporting requirements for emergingly competitive services apply only to price listed services, not to individually priced services. The Company stated that individually priced services account for a very small percentage of emergingly competitive revenues, and that producing the detailed information required under the tracker mechanism on these services would be time-consuming and expensive.

In its reply comments, the Department concurred with the Company. The Department also recommended requiring the Company to file annual reports stating total revenues from individually priced services and the percentage of emergingly competitive revenues such revenues constitute.

The Commission will not require the Company to file tracker reports for individually priced services at this time. Currently, those services do not account for a large enough percentage of emergingly competitive revenues to justify spending the time and money necessary to prepare those reports. However, the Commission will require the annual reports recommended by the Department to ensure prompt notification of any significant increase in revenues from those services. The Commission may, however, require more detailed reports, including reports conforming with the tracker mechanism of Minn. Stat. § 237.62, subd. 1a (d) (Supp. 1989), at a later date.

VIII. Inclusion of Competitive Services Customers in Sharing

The RUD-OAG requested reconsideration of the Commission's decision to allow customers of emergingly competitive services to participate in the sharing of increased earnings under the plan. The RUD-OAG's concern was that such sharing might inadvertently result in competitive services being priced under cost, in violation of Minn. Stat. § 237.60, subd. 4 (1988).

The Commission agrees with the Company that such concerns are theoretical at present and do not justify overhauling the sharing formula set forth in the June 7 Order. Currently, prices of competitive services are set well above cost; excluding customers who purchase them from sharing would effectively require these customers to subsidize the credits paid to customers of noncompetitive services. The Commission continues to believe that fairness requires that all customers of intrastate regulated services share in any excess earnings the provision of these services generates.

IX. "Required" Versus "Authorized" Rate of Return

Both the Department and the RUD-OAG asked the Commission to clarify the following paragraph from the June 7 Order:

> The Commission concludes that it is reasonable to determine whether it has substantial reason to believe that existing rates are inappropriate by considering current earnings in relation to a company's revenue requirement. If a company's existing rates do not result in over-earning, earning in excess of its <u>authorized rate of return</u>, the Commission can find that it does not have substantial reason to believe that existing rates are inappropriate.
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> Order, page 13, emphasis added.

These parties argued that it is a company's <u>required</u> rate of return, not its <u>authorized</u> rate of return, against which earnings should be measured in considering the appropriateness of existing rates. The Commission agrees.

Clearly, the initial inquiry in determining the appropriateness of existing rates is whether existing rates are allowing the company to earn in excess of its authorized rate of return. Even if the answer to that inquiry is no, however, existing rates may still be inappropriate if the company's authorized rate of return is unreasonably high in light of current economic conditions or other factors.

In this case the Commission did not determine a required rate of return, because Company earnings were below the rates of return ("benchmark" rates of return) advocated by all parties, as well as below the Company's authorized rate of return. This led to some imprecision in the use of these two terms.

The Commission will clarify, then, that the Department and the RUD-OAG are correct in their understanding that the Commission based its finding that the Company's existing rates were not inappropriate on a comparison between its earnings and its current required rate of return (or, as the Order states at page 13, its revenue requirement), not its authorized rate of return. The underlined phrase in the above-quoted portion of the Order should therefore read <u>required rate of return</u>, not <u>authorized rate of return</u>. Similarly, the second full paragraph on page 14 of the Order should contain an additional phrase:

> The overall rates of return earned by the Company in 1988 and 1989 were below the 10.64% level approved in the 354 Case. The overall rate of return and return on equity earned by the Company in 1988 and 1989 were below <u>the required return on equity or</u> the benchmark returns proposed by any interested person in this proceeding.
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> Order, page 14, additional material underlined.

X. Actual Versus Hypothetical Capital Structure

The Department and the RUD-OAG requested clarification that the Commission's use of actual capital structure in this proceeding does not signal a rejection of hypothetical capital structure in ratemaking or in other incentive plan proceedings. The Company opposed clarification as issuance of an advisory opinion.

The Commission's decision to use actual capital structure for purposes of this incentive plan was based on the specific facts of this case. It does not signify a change in the Commission's position on actual versus hypothetical capital structure in other cases, which will be decided on their individual merits.

XI. Economic Development Reports

The Department requested reconsideration of the Order's requirement that it submit annual reports on the impact of the Company's rural modernization program on economic development in non-metropolitan Minnesota. The Department stated that annual reports would be costly to prepare and would not yield as much reliable information as a single report encompassing a longer time frame.

The Commission will grant the Department's request and require a single report on January 1, 1994. The Commission agrees with the Department that the effects of the modernization program would not be quantifiable annually, especially during the early stages of the program. Requiring one comprehensive report will allow more efficient use of the resources of the Department, the Commission, and other parties.

XII. Time Frame for Company Response

Under Minn. Stat. § 237.625 (Supp. 1990), the modified incentive regulation plan will not take effect without the agreement of the Company. The Company has indicated it will be able to accept or reject the modified plan within 20 days of the date of this Order. The Commission will so require.

ORDER

1. There shall be no pass throughs of cost increases or decreases approved or reallocated by governmental entities
under the Company's incentive regulation plan.

2. The Company shall share earnings greater than those attributable to a 13.5% rate of return on equity in accordance with the sharing provisions set forth in the

June 7 Order.

3. The Company shall return to ratepayers all earnings in excess of those attributable to an 18.5% rate of return on equity, in accordance with the provisions of the June 7 Order.

4. The detailed reporting requirements of ordering paragraph 19 of the June 7 Order do not apply to individually priced services. Until further Order of the Commission, the Company need report only total revenues attributable to such services and the percentage of total revenues from emergingly competitive services those revenues represent.

5. The detailed reporting requirements of ordering paragraph 19 are not intended for the purpose of automatically imputing to the Company revenues in the amount of price reductions for emergingly competitive services.

6. The June 7 Order's discussion on determining the appropriateness of existing rates is hereby clarified as set forth in the body of this Order.

7. The June 7 Order's discussion of actual versus hypothetical capital structure is hereby clarified as set forth in the body of this Order.

8. On or before January 1, 1994 the Department shall file a report detailing the effects of the rural modernization program on economic development in non-metropolitan Minnesota.

9. Within 20 days of the date of this Order the Company shall make a filing indicating its acceptance or rejection of the plan as modified in the June 7 Order and as modified herein. If the Company accepts the plan as modified, it shall file its original plan, modified to incorporate the terms of this Order and the Order of June 7, on the same date. The Company shall serve both filings on all interested persons.

10. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Richard R. Lancaster
Executive Secretary

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